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FVCCF UPDATE 96 - 1

FEBRUARY 1996

AN INFORMATION RELEASE FOR FISHING VESSEL CAPITAL CONSTRUCTION FUND AGREEMENT HOLDERS

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1994 REPORTS NOW DELINQUENT

Reports on CCF agreement activity for tax year 1994 are now delinquent for most agreement holders. The reports to NOAA were due 30 days after the due date of the 1994 tax return (including extensions). Unless NOAA Form 34-82 for the 1994 tax year is received by April 1, 1996, the agreement will be classified as a non-filer in our report to the IRS. (The 1995 report will be due 30 days after the due date of your tax return.)

A full copy of your Federal tax return, as filed with the Internal Revenue Service, is required. Please securely attach the tax return to Form 34-82. *Please do not FAX Deposit/Withdrawal Reports or tax returns.* The "Preliminary Report" is no longer required.

ACTUAL DEPOSIT OF FUNDS REQUIRED

We recently became aware that some agreement holders do not understand that funds must be physically deposited in CCF depository accounts. A "constructive deposit" is only valid in the first taxable year of the agreement and prior to the effective date of the agreement. See UPDATE 94-1, page 2.

NOTE: *Keep all bank and investment account statements to verify deposit and withdrawal activity for your CCF agreement. IRS auditors verify deposits during their examinations.*

DEPOSITORY ACCOUNTS

During audits, the Internal Revenue Service may verify that the depository actually used matches the depository institution listed on the original CCF agreement (or amended agreement). Unless you are certain the correct depository information has been incorporated into the agreement, please notify us *by letter* of the currently correct information.

CAUTION: *Listing a new depository on NOAA Form 34-82 is not sufficient notice for us to amend the agreement.*

ADDING NEW DEPOSITORIES

When changing or adding a new depository you are required to provide us, in writing, with the Name of the Depository, City and State and date the account will be opened. This information should be provided in advance of opening the account. If in doubt about notifying us of past changes, provide this information to us, in writing, now.

COMPLETED SCHEDULE B PROJECTS - FINALIZE THE PAPERWORK

Review your CCF file to be certain that everything required by our letter of permission to withdraw was submitted to NOAA Fisheries. Keep copies for your records. These items are often missing:

Certificate of Documentation (CG-1270)

Certificate of Construction/Reconstruction for completed objectives

Statement of Actual Vessel Cost for vessel acquisitions

Completed Schedule A form

Copy of mortgage documents and loan amortization schedule

Schedule showing computation of tax basis

Copies of fish tickets (for vessels operating in a Conditional Fishery for 3 years prior to Acquisition or Reconstruction of the vessel)

Statement of Vessel Removal (newly constructed vessels operating in a Conditional Fishery)

NOTE *Permission to withdraw on a new project is expedited when files are complete with regard to old projects.*

REPORTS TO NOAA FISHERIES (NOAA FORM 34-82)

Please see newly revised instructions for the CCF Deposit/Withdrawal form. Frequent errors encountered include:

Balances carried forward do not agree with prior years ending balance

Form not signed and dated

Insufficient information provided under Description (Column B)

No entry in Schedule Reference No. (Column C)

New depositories appearing on form without NOAA being notified.

Reporting unrealized gains/losses

TAX RETURNS - REPORTING CCF TRANSACTIONS

Consult 1995 IRS Publication 595 TAX GUIDE FOR COMMERCIAL FISHERMEN and Revenue Ruling 94-26 for reporting requirements. For Individual tax returns (Form 1040), IRS instructions in Publication 595 explain reporting of the taxable income reduction for CCF deposits according to the source of the deposit

Earnings from vessel operations reduce line 37, page 2 of Form 1040. IRS instructions say to write "CCF" and the amount of the deduction in the left margin.

Vessel sale or disposition income is generally reported on Form 4797. IRS instructions are not specific about how to disclose redeposit of net proceeds of vessel disposition on Form 1040. Until the IRS provides specific instructions, you may wish to enter the deposit of vessel disposition proceeds on Form 4797:

Enter the transaction as usual on Form 4797 and carry the gain and ordinary income to summary lines 32 and 33. Enter an amount on line 34 that is corrected for the CCF deposits. Show the amount of the CCF deposit and "Deposit of Net Proceeds to CCF" next to the entry. Add a note to the tax return explaining your entry and showing your calculation of net proceeds.

Interest and Dividends earned on CCF deposits should be listed on Schedule B of Form 1040; identify them as *CCF earnings*. If these earnings are left on deposit, tax may be deferred on these income items. On another line of Schedule B, subtract the same amounts and identify them as *CCF deposits*. When depository earnings are reported in this way, IRS electronic matching program should be able to tie information furnished by financial institutions (on Form 1099) to Individual tax returns. This should prevent a number of computer generated inquiries from the IRS about these depository earnings.

For business returns, see IRS Publication 595.

IRS NOTICES ON 1994 TAX RETURNS

Some agreement holders received notices from the IRS generated by an automated program that screens Form 1040 returns for Alternative Minimum Tax status. This program does not properly identify CCF taxable income reductions made on page 2, line 37 of Form 1040. Federal tax is incorrectly recomputed to include Alternative Minimum Tax. Generally the situation can be rectified by sending a response to the service center that includes a copy of CCF instructions printed in IRS Publication 595 - TAX GUIDE FOR COMMERCIAL FISHERMEN.

IRS AUDITS

Often we are contacted by the Internal Revenue Service to verify that information in our case files corresponds with information they gather in the field. Unfortunately, we cannot verify information that has not been provided to us.

NOTE: Review and update all CCF agreement documentation while preparing the 1995 tax return.

NONQUALIFIED WITHDRAWALS - PENALTY AND INTEREST

Any withdrawal that is not a Qualified Withdrawal is considered to be a Nonqualified Withdrawal. A Qualified Withdrawal is used only for the acquisition, construction, reconstruction or principal payment on a mortgage for a qualified agreement vessel which meets all of the requirements contained in 50 CFR Part 259.31. Exceptions:

In some situations, a transfer may be made from one CCF agreement to another CCF agreement. *Prior permission of NOAA Fisheries is required for **each** transfer.*

Current year earnings may be withdrawn from the depository account if they were automatically deposited into it. (We recommend depositing these earnings in a separate account.)

Penalty and Interest on a Nonqualified Withdrawal was changed by the Tax Reform Act of 1986. The penalties are particularly severe for Individual taxpayers because of added tax brackets for high income taxpayers. Individuals who are partners, shareholders, and members of passthrough entities must pay the penalty tax rate for transactions by a partnership, S-Corporation, or LLC.

For Individual taxpayers:

- Penalty - A Nonqualified Withdrawal is taxed at the highest marginal rate of tax (39.6% for individuals) for the year of the withdrawal. Nonqualified Withdrawals are not included with other taxable income. The penalty rate of tax is applied separately to it, and the tax (plus interest on the period of tax deferral) is added to other taxes due. (Deposits made from capital gain income and those that did not defer taxes have separate treatment.)
- Interest - Interest is computed on the deferred taxes. The interest rate (applied to the tax computed above) was 7.18% for 1995 Nonqualified Withdrawals. This rate is multiplied by the number of years since tax was deferred on the funds withdrawn (on a first-in-first-out basis). The interest rate is re-computed annually; the 1996 rate is not yet available.
- No offsets - Nonqualified withdrawals are not offset by other net operating losses and do not reduce AGI or taxable income.

Individual taxpayers include the tax and interest for Nonqualified Withdrawals on line 54 of Form 1040. Attach a schedule of your computation. See IRS Publication 595 for details.

CAUTION: *Since penalties on Nonqualified Withdrawals was changed by the TRA 1986, any materials on CCF (including regulations) written prior to 1987 may refer to earlier law. Refer to IRS Publication 595 for specific reporting instructions.*

WITHDRAWAL RATIFICATION

As noted in earlier updates, verbal approval is not given for withdrawals. In an emergency, funds may be withdrawn from a CCF depository for an otherwise valid objective. A request must subsequently be made to NOAA Fisheries to "ratify" the withdrawal as Qualified. We do not recommend after-the-fact ratification, except in emergencies.

Capital Construction Fund Regulations for Fisheries under 50 CFR Part 259, under the authority of the Merchant Marine Act Section 607 (46 U.S.C. 1177) allow us to ratify a withdrawal (as qualified) that is made before obtaining our consent. This is possible for any given tax year, under the regulations, but only if permission is requested prior to the filing date of the tax return for the tax year in which the withdrawal was actually made. If the after-the-fact "ratification" process is used, please pay particular attention to the following items:

Requests for ratification of withdrawals should be in writing and include either an updated Schedule B or a new one that describes the project as presently planned, including the project's start date.

The request must include the date the withdrawal(s) was made from your CCF account and the amount of the withdrawal(s).

The request should be submitted at least 45 days **before** the tax return for the year is due.

Send all project documentation available (e.g., Coast Guard Documentation, statement of vessel cost, etc.) with the request for ratification of a Schedule B withdrawal.

NOAA's will only ratify a withdrawal as Qualified when a good-faith effort has been made to bring the agreement into good standing at the time of the request for ratification. Any deficiencies in file documentation must be cured within 30 days of notice.

Permission to withdraw on any new project requires that the agreement be in good standing, which requires that all old projects are properly documented (see page 2 of this UPDATE).

CAUTION: *Beginning work on a new project without properly closing out documentation on earlier projects jeopardizes the qualification of withdrawals for the old project as well those for the new one.*

REQUIRED RECONSTRUCTIONS

A vessel reconstruction project is usually required when CCF funds are used to acquire a used vessel. A separate Schedule B objective is issued for the reconstruction project. Permission to withdraw is required for each reconstruction project (Schedule B) as well as for vessel acquisitions and construction projects. Special rules concerning reconstruction projects include:

Minimum Expenditures - CCF Regulations require that a reconstruction project must be for a minimum cost of 20 percent of vessel cost or \$100,000, whichever is less. A reconstruction may include rebuilding, replacing, reconditioning, converting and/or improving any portion of a vessel. It must prolong the useful life of the reconstructed vessel, increase its value, or adapt it to a different commercial use in the fishing trade or industry. See 50 CFR Part 259.31 for specific rules.

Time Limit - CCF Regulations for fishing vessels require that construction and reconstruction objectives be completed within 18 months of starting the reconstruction project, unless otherwise consented to by NOAA. Failure to complete the objective within this 18-month "window" will jeopardize the qualification of all withdrawals for the vessel. See 50 CFR Part 259.31(c) for specific rules.

Time Allowed After Vessel is Acquired - CCF Regulations require that upon acquisition of a used vessel, which is greater than 5 years old at the date of acquisition, you must complete a reconstruction on that vessel within 7 years. If the vessel is 5 years old or less at the date of acquisition, you have the option of either constructing a new vessel within 10 years or reconstruction of the acquired vessel or a present Schedule A vessel within 7 years. (Also see 18-month rule, above) See 50 CFR Part 259.31 for specific rules.

CAUTION: *Failure to complete the required reconstruction or construction will most likely result in withdrawals made for the original acquisition and related reconstruction or construction being rendered non-qualified.*

REIMBURSING OPERATING FUNDS

Payments made outside of your CCF account (ie., from a general operating bank account or personal account) during a particular tax year, if they would otherwise be a qualified expenditure, are reimbursable from your CCF account *on or before your tax due date*, with extensions, for filing that year's tax return.

NOTE: *NOAA's prior approval is still required for these withdrawals.*

ADDRESS CHANGE FOR CCF PROGRAM

Please note the following address change for mail and overnight delivery services:

CCF Program (F/IS1)
NOAA/National Marine Fisheries
1315 East-West Highway, 13th Floor
Silver Spring, MD 20910-3279

Our telephone number has not changed.

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